

January 2010

Investing In Real Estate For 'Cash Flow' Can Be A Gold Mine BUT Don't Get Caught Out

Common sense says that the less cash you need to fund your investment the better off you are. As a rule of thumb, property in a city location – particularly inner suburbs - offers considerably lower yields than property in country and regional areas. There's usually a trade-off between yield and capital return: city investment prices have tended to outstrip non-urban prices in terms of capital appreciation; therefore an inner-city apartment might have a low yield (due to the high purchase price) but demonstrate strong capital growth (historically), whilst country properties might return a high rental yield but demonstrate lower capital growth.

The truth is that positive cash flow property is a bit like the Tasmanian tiger: they exist but finding them is another question. You can find them but you'll generally only find them in suburbs or towns which present the investor with changing questions: "Do I really want to invest here?" We are not taking an overly negative view of such opportunities but do suggest investment on cash flow grounds need consideration of certain criteria:

1. A regional or rural town must have a population base of at least 2,000 dwellings
2. Real estate should indicate a future growth rate of better than five per cent, and
3. A property should show a gross rental yield of better than five per cent.

Tax matters

A high marginal rate tax payer derives significant benefit from receiving marginal tax cuts while (depending on the timing of any sale), paying tax on only 50 per cent of the capital profits generated.

A low growth/high yield strategy is likely to suit those on lower incomes as the extra rent may allow them to fund an additional property. The lower income earner has fewer dollars available for funding their investments. Indeed some lower income earners who aspire to be property investors simply cannot afford to fund a negative cash flow.

Positive cash flow investing means that you have more money coming in from a rental property than is going out. It is the cash left over after allowing for cash costs of mortgage, insurance, interest, maintenance expenses, and supplemented by the non cash tax deductions (depreciation etc). If the operating expenses exceed annual income, the tax break becomes tax back in your pocket.

When the after tax effects are added in to the investment equation and a positive result is achieved then you have positive cash flow from a property investment:

Positive cash flow investing remains vastly misunderstood by many investors.

Whether an investor finds a property that generates a positive cash flow depends on many things: rental income, the interest rate, allowable deductions, and your own marginal tax rate. As a simple rule of thumb threshold gross rental yield of around 8 per cent is needed to achieve positive cash flow, however (as mentioned above), this depends on the numbers involved with each specific property.

This should not be taken as a magic number, rather as just one of a number of selection criteria. The other issue is that of real long-term capital growth. This may mean eschewing fashionable urban areas in favour of drab, industrial suburbs or, as discussed earlier, regional or country towns.

A word of warning: if you are focusing on positive cash flow investments and considering investing in regional or country areas (for example), you **MUST** develop an intimate understand and knowledge of the issues involved and how best to proceed otherwise it could cost you **BIG TIME**.

Yield investors need to have their calculator ready to 'do the numbers'. This involves making an estimate of the potential income (remembering to build in a vacancy factor of say, 2-4 weeks a year **and** the costs associated with advertising the vacancy), then adding up all the costs, including potential repairs. The remaining figure will be the amount of cash flow. Tax deductions in relation to depreciation on buildings, fixtures and certain contents will boost yields further as these are non-cash, tax deductible expenses in the year they are applied.

Risks

A regional or rural investor attracted by high rental yields must be concerned about the local economy. Investors feeling warm and fuzzy about high regional yields need look closely at the local economy.

Investors in regional towns are faced with higher risk than their city counterparts. In some towns you have to wonder whether there will be any population growth at all. If there isn't going to be any real economic growth in a town then investors need to be compensated with a much higher rental yield. Intending investors need to conduct a risk review that considers local economy risk as well as the more general risk of interest rate rises.